

AMOCO PRODUCTION CO.

IBLA 90-142

Decided April 30, 1993

Appeal from a decision of the Director, Minerals Management Service, directing payment of additional royalties for production from Federal oil and gas lease No. 284-017031-0. MMS 87-0005-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties: Natural Gas Liquid Products

MMS may properly require a lessee selling unprocessed casinghead gas at the wellhead pursuant to an arm's-length "percentage-of-proceeds" contract to value such gas for royalty purposes at an amount equal to one-third of the value of natural gas liquids plus the full value of residue gas.

APPEARANCES: Ruth Brammer Johnson, Esq., Mary Viviano Laitos, Esq., Robert G. Leo, Esq., Denver, Colorado, for appellant; Howard W. Chalker, Esq., Office of the Solicitor, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HUGHES

Amoco Production Company has appealed from a decision of the Director, Minerals Management Service (MMS), dated September 14, 1989, denying an appeal from a decision of the Royalty Compliance Division (RCD),

MMS, directing payment of \$17,192.85 in additional royalties. The royalties at issue are attributable to casinghead gas production from lease No. 284-017031-0, Billings County, North Dakota, during the period April 1981 through March 1983. The casinghead gas was produced from two wells, Armor B-1 and Armor C-1, which also produced crude oil.

The facts are not in dispute. Amoco sold its share of casinghead gas to Koch Hydrocarbon Company (Koch) pursuant to an arm's-length contract entered May 14, 1981. Under the contract, Amoco sold its gas at the wellhead, and title passed to Koch at that point. Koch then processed the gas to recover natural gas liquid products (NGLP), sulfur, and dry residue gas. Koch paid Amoco an amount equal to "seventy-five percent (75%) of the net sales proceeds received for the liquefiable hydrocarbons, residue gas and sulfur saved and sold \* \* \* less the fees attributable thereto" (Amoco-Koch Gas Processing Agreement Sec. 7.1 (quoted in RCD Memorandum, Aug. 11,

1988, at 4)). Amoco refers to a contract of this type as a "percentage-of-proceeds contract." 1/

Amoco valued its casinghead gas for royalty purposes at an amount equal to the price it received from Koch under their contract, i.e., at 75 percent of the sales proceeds of NGLP, sulfur, and dry gas, less fees for compression, electrical power, and treating. In 1986, the North Dakota State Auditor, acting pursuant to section 205 of the Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. § 1735 (1988), reviewed this valuation and concluded that Amoco had underpaid royalties by \$17,192.85. RCD agreed by decision of November 12, 1986. Amoco then appealed RCD's decision to the Director, MMS, and it is the Director's decision that we review here.

The Director concluded that Amoco should have valued its casinghead gas at an amount equal to the full value of the residue gas plus one-third of the value of the NGLP and sulfur (MMS Decision at 5). 2/ Such valuation was consistent with Notice to Lessees and Operators of Federal and Indian

1/ Amoco states that under such a contract "a lessee sells gas at the wellhead before processing, but is paid based upon the value of the gas after processing, less actual processing costs" (Statement of Reasons at 2 n.3). In a proposed rulemaking, MMS noted that such contracts are typically

"a direct result of oil well production where associated casinghead gas production occurs in sufficient volumes that venting or flaring of the gas is considered wasteful, or the volumes cannot be flared or vented due to environmental reasons. The volume of gas produced from any one lease is usually insufficient to justify the expense for each lessee to build a processing plant to handle its own lease production. Thus, a plant is built in a centralized location to handle the production from the various leases producing casinghead gas in the field or area."

53 FR 50422 (Dec. 15, 1988).

2/ The Director observed that "it has been the longstanding Federal policy that the royalty value of any manufactured liquid products may reflect a maximum two-thirds allowance for processing costs," resulting in royalty being calculated on "one-third of the value of the extracted liquids" (Director's Decision at 2). That deduction, recognized for onshore production by 30 CFR 206.106 (1983) and for offshore production by 30 CFR 206.152(a)(2) (1983), is referred to as a "manufacturing allowance." See Exxon Co., U.S.A. (On Reconsideration), 121 IBLA 252A, 252B, 98 I.D. 191, 192 (1992).

The use of one-third of the value of NGLP is based on a deduction of a manufacturing allowance of up to two-thirds of the value of the NGLP. See 30 CFR 206.106 (1983). That deduction could be less than two-thirds, depending on the actual costs of manufacturing the NGLP. Thus, the royalty value may be more than one-third of the value of the NGLP.

We note that, under 30 CFR 206.106 (1983), an allowance of up to two-thirds of the value "of all casing-head or natural gasoline, butane, propane, or other liquid hydrocarbon" is made "for the cost of manufacture." Although sulfur does not appear to be covered, the propriety of using that

Onshore Oil and Gas Leases (NTL-5), 42 FR 22610 (May 4, 1977), applicable regulations, and longstanding Departmental practice, the Director held. Id. We affirm.

[1] The leasing statutes (the Mineral Leasing Act, 30 U.S.C. §§ 181-287 (1988), and the Mineral Leasing Act for Acquired Lands, 30 U.S.C. §§ 351-359 (1988)), Departmental regulations, and lease terms reserve to the Secretary of the Interior the authority and responsibility to establish the reasonable value of production for royalty purposes. See Jicarilla Apache Tribe v. Supron Energy Corp., 728 F.2d 1555, (10th Cir. 1984), aff'd in part and rev'd in part, 782 F.2d 855 (10th Cir.), modified, 793 F.2d 1171 (10th Cir.), cert. denied, 479 U.S. 970 (1986); Marathon Oil Co. v. United States, 604 F. Supp. 1375 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987); California v. Udall, 296 F.2d 384 (D.C. Cir. 1961); Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); United States v. Ohio Oil Co., 163 F.2d 633 (10th Cir. 1947), cert. denied, 333 U.S. 833 (1948).

At all relevant times, regulation 30 CFR 206.105(c) (1983) provided: "For the purpose of computing royalty, the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater." (Emphasis added.) 3/ According to A Dictionary of Mining, Mineral, and Related Terms (1968) at 180, "casinghead gas" is "[n]atural gas rich in oil vapors." It is "[s]o named as it is usually collected, or separated from the oil, at the casing head." It is "[f]requently called combination gas or wet gas." We agree with MMS both that casinghead gas is "a form of wet gas" (Answer at 1), and that 30 CFR 206.105(c) accordingly applies here. Id. at 3.

Regulation 30 CFR 206.105(c) (1983) was carefully analyzed as follows by Circuit Judge Seymour in Jicarilla Apache Tribe v. Supron Energy Corp., supra at 1568:

The second clause of [30 CFR 206.105(c) (1983)] authorizes Interior to use the aggregate value of the substances contained in wet gas, ensuring that the lessor will receive the true value of the gas and other hydrocarbons produced from its lands, regardless

fn. 2 (continued)

allowance for sulfur produced from offshore leases may be properly considered only in the context of an appeal directly challenging the granting or denial of such allowance where sulfur or other non-hydrocarbon is being extracted and sold. See Exxon Co., U.S.A. (On Reconsideration), 121 IBLA at 252D n.2, 98 I.D. at 193 n.2. MMS' apparent decision to authorize a manufacturing allowance for sulfur has not been challenged here.

3/ That regulation and others herein were redesignated on Aug. 5, 1983. 48 FR 35641. All citations are to the 1983 Code of Federal Regulations. A major revision of the Department's valuation regulations occurred in 1988, and these new provisions are set forth at 30 CFR 206.100 (oil) and at 30 CFR 206.150 (gas). However, the 1988 revision applies only prospectively.

of the lessee's choice of marketing tactics. Subsection (c)

does not by its terms require that the lessee itself extract liquids before the Secretary may utilize aggregate value computing; to the contrary, it appears to apply in all situations. By using the term "aggregate value," rather than "proceeds," the subsection allows the Secretary to use aggregate value in situations where the lessee does not in fact process wet gas or otherwise directly receive "proceeds" from the processing. [Emphasis in original.]

728 F.2d at 1568. 4/ In Kerr-McGee Corp. (Kerr-McGee II), 125 IBLA 279, 285 (1993), the Board quoted this passage from Jicarilla with approval in affirming a decision of the Director, MMS, involving facts nearly identical to those here.

Amoco argues on appeal that it properly valued its casinghead gas at an amount equal to the gross proceeds it received from its arm's-length sale of that gas at the wellhead to Koch. It argues that the Department has accepted such a valuation method for over 40 years, and that this method is fully consistent with the "valuation alternatives" set forth at 30 CFR 206.103 (1983). Under that regulation, Amoco stresses, the value of production must be the estimated reasonable value of the product as determined by the Associate Director, "due consideration being given to the highest price paid for a part or a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters." (Emphasis added.)

Regulation 30 CFR 206.103 (1983) is a general provision applicable to all production, not just to wet gas. Read in its entirety, it actually provides that the amount received by the lessee for sale of production ("the gross proceeds accruing to the lessee from the sale" of production) does not always establish value. Although production may not be valued at less than the amount received by the lessee, it may be valued at more than that amount if it is less than the "estimated reasonable value of the product" as determined by MMS, based on various factors against which the price received by the lessee is compared. The "price received by the lessee" is only one of those factors, and it is not, per se, controlling.

The provisions of 30 CFR 206.105(c) (1983) expressly authorized MMS to adopt the valuation it used to value the wet gas produced from Amoco's lease, and 30 CFR 206.103 (1983) does not provide to the contrary. MMS was not required to accept Amoco's gross proceeds as royalty value. Kerr-McGee Corp. (Kerr-McGee I), 106 IBLA 72, 82 (1988).

To support its conclusion that MMS has always accepted gross proceeds as royalty value, Amoco quotes the Conservation Division Manual (CDM): "Where gas was sold at the well head, previous Division policy was that royalty was generally based on the price received by the lessee under an arm's length contract \* \* \*." CDM 647.2.1 Exh. 1 (Release No. 35, Aug. 15,

4/ Although Indian lands were involved in Jicarilla, Judge Seymour's analysis does not rely upon this fact for the conclusions he draws above.

1977) (Statement of Reasons at 5-6). MMS notes in response that Amoco fails to quote the entire paragraph in that notice, which continues: "[W]here the gas was processed for extraction of entrained liquids, Division policy was that the royalty would be based on the value of the residue gas plus one-third, (or the [lessee's] portion if greater than one-third), of all extracted liquids" (Answer at 8-9). That is exactly how MMS valued Amoco's gas here.

Amoco also submits that the Department has long recognized the unique characteristics of percentage-of-proceeds contracts. It quotes in support a letter dated January 29, 1947, from the Director, Geological Survey (GS), to the Secretary stating:

[T]he above-mentioned sections of the 1936 and 1942 regulations [5/] are based on the faulty premise that the cost of manufacture will always be reflected in the retention by the processor of a portion of the extracted liquids only and in the cases here under consideration where the cost of manufacturing is expressed in the retention by the processor of both gas and liquids, it is apparent that certain inequities in royalty computation have resulted.

(Letter, Jan. 29, 1947, from the Director, GS, to Acting Secretary Chapman (Chapman Letter) at 3 (reproduced at CDM 642.3.1A (S50) Appendix, Release No. 4, July 12, 1961); quoted in Statement of Reasons at 6).

Once again, Amoco fails to set out the whole story. In a portion of the Chapman Letter not quoted by Amoco, the GS Director proceeded to recommend that, whenever the cost of manufacture of natural gas is reflected in both gas and liquids retained by the processor, 6/ the value for royalty purposes of such natural gas should be computed on the basis of "the gross market value of all such products less extraction cost" or on the basis of "one-third of the gasoline, butane, propane, and other liquid substances extracted from the gas and all of the residue gas available for sale," whichever results in the greater royalty (Chapman Letter at 4). See Kerr-McGee I, 106 IBLA at 79. This letter was approved by Acting Secretary Chapman on February 28, 1947, and GS thereafter apparently adopted that valuation method. We are unable to see that the 1947 letter established a method for percentage-of-proceeds contracts at variance with the method

5/ Section 3(h) of the 1936 regulations stated in part:

"A royalty as provided in the lease shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casing-head or natural gasoline extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture, and no royalty thereon is required."

Regulation 30 CFR 221.51, 7 FR 4132 (June 2, 1942), is to the same effect.

6/ Koch charged Amoco for processing both the gas and liquids here in lieu of retaining them. Thus, it can be argued that the circumstances alluded to in this letter pertain in Amoco's case as well.

applied here by MMS. Indeed, it appears to reinforce the validity of requiring Amoco to use the net-realization method. 7/

Amoco also relies upon NTL-5, which was effective June 1, 1977, and directed that the base value for royalty purposes of natural gas was the higher of the sales contract price received by the lessee or the highest applicable ceiling rate established by the Federal Power Commission (FPC). 8/ Amoco points out that, when the market for gas declined in the early 1980's, lessees could no longer obtain the highest applicable ceiling rates from their purchasers. As a result, Amoco states, MMS notified lessees as early as January 18, 1983, that it would accept gross proceeds received under an arm's-length contract as the basis for valuing production. 9/

Effective August 1, 1986, MMS amended NTL-5 to afford lessees relief from its ceiling rate provision, but that relief applied only prospectively. The amendment expressly provided that the value of natural gas for royalty purposes would be established pursuant to 30 CFR Part 206. 51 FR 26759, 26765 (July 25, 1986). This action was followed by Congressional enactment of the Notice to Lessees Numbered 5 Gas Royalty Act of 1987 (NTL-5 Act), P.L. 100-234, 101 Stat. 1719 (1988), which granted similar relief retroactive to January 1, 1982. Section 3(b) of that Act provided:

If the gas \* \* \* was produced from a Federal onshore or Indian lease, the value of production for the purpose of computing royalty, shall be the reasonable value of the product as determined consistent with the lease terms and the regulations codified at part 206 of Title 30, Code of Federal Regulations, in effect at the time of production.

Section 3(b) then essentially quotes the provisions of 30 CFR 206.103 (1983), discussed above. 10/

Amoco argues that each of these actions validated the Secretary's acceptance of arm's-length proceeds, in lieu of ceiling prices, in valuing production for royalty purposes.

7/ Amoco emphasizes the phrase "available for sale" in its reply brief of June 8, 1990, but this phrase simply acknowledges the practice of the Department to compute royalty on residue gas at "the full volume available for sale less any small amounts used in actual plant operations." (Chapman Letter at 2 (emphasis added)).

8/ Congress has specifically recognized that NTL-5 was a duly promulgated regulation of the Department within the meaning of the Administrative Procedure Act. See S. Rep. No. 234, 100th Cong., 1st Sess., 5 (1987).

9/ Amoco identifies this notice as a letter from James R. Detlefs, Chief, Lessee Contract Branch, MMS, to Cotton Petroleum Corporation. No copy of this letter is included in the record.

10/ MMS procedures for implementing the Act were set forth at 53 FR 5654 (Feb. 25, 1988).

As a result of the NTL-5 Act, the terms of NTL-5 were in effect only during the first 9 months of Amoco's production here, i.e., from April through December 1981. As noted above, NTL-5 established as a base value for royalty purposes the higher of either the price received by the lessee in accordance with its sales contract or the highest applicable ceiling rate established by the FPC. <sup>11/</sup> However, it is significant that an adjustment, known as the "liquid adjustment factor," was authorized if the base value did not properly reflect the value of entrained liquids in the gas. 42 FR 22611 (May 4, 1977). <sup>12/</sup> The CDM clearly provided that the "[u]se of the liquid adjustment factor" was intended to "ensure that royalty values are at least equal to the values which would have been determined under the net realization method." CDM 647.2.3G (Release No. 35, Aug. 15, 1977) (emphasis supplied). Thus, it was proper for MMS to value casinghead gas produced from April through December 1981 under the net-realization method, that is, at an amount at least equal to the sum of one-third of the value of all NGLP (and, arguably, sulfur) <sup>13/</sup> plus 100 percent of the value of residue gas. The decision under appeal valued Amoco's production in this manner.

For the remainder of the audit period, i.e., from January 1982 through March 1983, section 3(b) of the NTL-5 Gas Royalty Act (quoted in part above) required valuation of Amoco's gas to be in accordance with "the lease terms and regulations codified at part 206 of title 30, Code of Federal Regulations, in effect at the time of production." Section 3(b) admittedly quotes 30 CFR 206.103, which requires MMS to give "due consideration" to, inter alia, "the price received by the lessee" for production. However, as discussed above, that regulation, read in its entirety, actually provides that the amount received by the lessee does not establish value. Further, Section 3(b) may not be read as barring reference to the other provisions of Part 206 in effect at the time of production. Kerr-McGee II, 125 IBLA at 284. The discretion given to MMS by 30 CFR 206.103 may not be exercised in a manner incompatible with 30 CFR Part 206 as a whole. Where valuation of wet gas as the price received by Amoco (gross proceeds) would be less than that computed by the net-realization method, regulation 30 CFR 206.105(c), which was in effect at all relevant times, expressly required valuation in the higher amount. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1382 (D. Alaska 1985), makes clear that gross proceeds is a floor value.

We are persuaded by MMS' Answer that there is no issue here as to whether the relief provisions of the NTL-5 Act were properly applied here. Compare Kerr-McGee I, 106 IBLA at 82. MMS explains that the amount that Koch paid to Amoco for the residue gas was the same as the ceiling price

<sup>11/</sup> The latter amount was interpreted to be the highest applicable ceiling price administered by the Federal Energy Regulatory Commission under the Natural Gas Policy Act of 1978, 15 U.S.C. § 3301 (1988). S. Rep. No. 234, 100th Cong., 1st Sess. 4 (1987).

<sup>12/</sup> The base value was also adjusted to reflect the British Thermal Unit (BTU) content of the gas. 42 FR 22610 (May 4, 1977).

<sup>13/</sup> See note 2, above.

established by the Natural Gas Policy Act of 1978 (Answer at 5, Exh. 1). Thus, it does not appear that Amoco is being asked to pay royalty on an amount higher than that required by the NTL-5 Act (Answer at 6-7).

Amoco contends that the Secretary's longstanding acceptance of a gross proceeds valuation method cannot be retroactively altered by using an audit proceeding. Amoco charges that the decision under appeal wrongly adopts a new methodology retroactively using the audit process. Citing Continental Oil Co. v. United States, 184 F.2d 802, 821 (9th Cir. 1950), Amoco contends that the Director's decision contradicts prior case law holding that the Secretary may exercise his authority to establish royalty values only prospectively. It is arbitrary, capricious, and an abuse of discretion, Amoco argues, for the Secretary to change the royalty valuation methodology upon which Amoco has relied for years. Amoco submits that such change requires that it calculate royalties based upon a comparison between its gross proceeds and an aggregate value and imposes substantially different business practices and recordkeeping requirements. It contends that MMS' decision in effect requires it to perform dual accounting for leases with arm's-length percentage-of-proceeds contracts.

Amoco focusses on our statement in Supron Energy Corp., 46 IBLA 181, 192 (1980), construing Continental Oil Co. v. United States, *supra*, to require that "where the Department has specified that a method of valuation is adequate, it may not assert that this method is incorrect or incomplete and reassess value retroactively in order to raise the royalty due." We are unpersuaded that the Director's decision is an improper retroactive application of a new valuation method. It is evident from Supron Energy Corp., *supra*, in general and the discussion above that the net-realization method has long been recognized as a valid method of valuing production for royalty purposes, even though it may impose dual accounting responsibilities on a lessee. The law has consistently been that royalty is due on the higher of gross proceeds and value as determined by net-realization methods. We perceive no new methodology here.

Amoco cites to statements made by MMS "in a host of \* \* \* notices that it will accept gross proceeds under arm's-length contracts as a basis for calculating royalty." Statements made by MMS concerning whether NTL-5 might apply cannot be read as overcoming the law as clearly set out in governing regulations. More generally, the fact that proceeds from arm's-length contracts would be acceptable as value in some circumstances does not mean that MMS is bound to accept them in every case. <sup>14/</sup> Where MMS' decision not to accept them is supported by law, it is properly affirmed.

<sup>14/</sup> For example, Amoco has provided a copy of a letter to Phillips Petroleum Company from MMS dated Aug. 4, 1983, stating:

"[MMS] is now in the process of issuing regulations and product value guidelines implementing a Secretarial decision concerning valuation for royalty calculation purposes, of natural gas sold under the terms of an arm's-length contract. \* \* \* MMS will accept gross proceeds received under a properly negotiated arm's-length contract as the basis for calculating

Amoco's strongest case in favor of prospectiveness is present for the period April through December 1981 when NTL-5 was in effect. There, arguably, the Department had issued an order (NTL-5) analogous to the June 1931 order present in Continental 15/ and later sought to reassess royalty retroactively. However, the discussion above of NTL-5 (and the liquid adjustment factor set out in the CDM) makes clear that a valuation under NTL-5 had to at least equal a valuation under the net-realization method now being imposed by MMS. Thus, the "reassessment" here (requiring that Amoco value production by the net-realization method) is no different than what MMS was authorized to do while NTL-5 was in effect. Although it technically works a retroactive reassessment, Amoco has not been harmed by the Director's decision.

The Director's decision is consistent with our decision in Supron Energy Corp., supra, where we examined whether MMS could properly require a lessee to value its production for a prior 2-year period under a system of dual accounting. Under such system, Supron was required to value its production using the net-realization method and the BTU method and redetermine its royalties based on the method yielding the higher value. Supron affirmed MMS' action. 16/ Jicarilla Apache Tribe, supra, reached a similar

fn. 14 (continued)

royalties on gas produced on Federal leases. \* \* \* The Payor's Handbook will be revised to reflect this new policy."

(Amoco's Reply at Exh. A (emphasis supplied)). This notice appears to be a reference to the change in Departmental policy that culminated in 1988 in the amendment of Departmental valuation regulations. However, that amendment was prospective only and did not cover the period in question. 53 FR 1184, 1238 (Jan. 15, 1988). We do not see it as a determination that arm's-length contract price would control in all circumstances.

15/ In Continental, the Department had issued two orders. The first, dated June 4, 1931, advised lessees that the minimum price basis for royalty settlements on gas in California had been fixed at \$0.05 per 1,000 cubic feet and on natural gas gasoline in Kettleman Hills at \$0.06 below the current published San Francisco price for gasoline in tank wagon lots. Those prices were to be used in computing royalty unless the lessee received a greater price. Later that same month, the minimum price for natural gas gasoline was tied to the retail market. On June 7, 1937, the Department issued a second order altering this policy. This second order recognized that the two-thirds allowance granted by section 4(d) of the

1926 regulations at times overcompensated lessees for manufacturing costs. The order, therefore, called for a valuation of natural gas at the greater of "the combined value of such products as measured by the lessee's gross field realizations less his actual extraction costs" or the aggregate value computed by section 4(d). 56 I.D. 462, 465 (1937) (emphasis added). The trial court construed this 1937 order to operate prospectively only, United States v. General Petroleum Corp., 73 F. Supp. 225, 256 (S.D. Cal. 1946), and the Ninth Circuit affirmed. Continental Oil Co. v. United States, 184 F.2d 802, 821 (9th Cir. 1950).

16/ Although Indian leases were involved in Supron, a lease provision and regulation similar to 30 CFR 206.105(c) were present to support the Department's requirement.

result on the issue of prospectiveness. There the Tribe won a declaratory judgment obligating the Secretary to require lessees to account for the prior 9-year period by a system of dual accounting. 479 F. Supp. 536, 553 (D.N.M. 1979).

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Director is affirmed.

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David L. Hughes  
Administrative Judge

I concur:

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James L. Byrnes  
Chief Administrative Judge